[COMMITTEE PRINT]

PROPOSED INCOME TAX CONVENTION BETWEEN THE UNITED STATES AND THE UNION OF SOVIET SOCIALIST REPUBLICS

PREPARED FOR THE USE OF THE

COMMITTEE ON FOREIGN RELATIONS

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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INTRODUCTION

There is presently no income tax convention between the United States and the Union of Soviet Socialist Republics (U.S.S.R.). Adoption of the proposed U.S.S.R. income tax convention is desirable for a number of reasons. Over the years, there has been limited contact between the United States and the U.S.S.R. with the result that the citizens and businesses of each country have had little contact with the tax system of the other country. However, it appears that there will be an increasing amount of economic and cultural contact between the two countries which could generate an increasing number of tax problems.

Recently there has been a trend toward modernization and standardization in international tax relationships. The model income tax convention of the Organization for Economic Cooperation and Development (OECD) and the recent revision of many U.S. income tax treaties (for example, the Japanese and Norwegian Conventions) are examples of this trend. However, the proposed U.S.-U.S.S.R. Income Tax Convention does not conform to this pattern and does not deal with many of the matters which are normally covered in United States income tax conventions. It is probable that this difference is attributable to the contrasting political and economic systems of the two countries. U.S.S.R. nationals are not permitted to hold investments in foreign countries and foreign entities are required to deal through State trading companies. Moreover, business with a State trading economy is done on a significantly different basis than with a free market economy. Additionally, the U.S.S.R. has had relatively little experience in dealing with market economy countries and their tax laws, in contrast to some of the other non-market economy countries which have in the not too distant past had experience with free market economies.

As a result, the Soviet tax structure is less developed in respect to foreign entities and persons than is the tax structure of other non-market countries. Therefore, many of the articles which are contained in the more recently negotiated income tax conventions between the United States and other countries have been either substantially modified or excluded from the proposed treaty.

Because of this lack of experience in dealing with types of economies of the other country, either the U.S.S.R. or the United States may terminate the proposed convention at any time after 3 years from its entry into force (rather than 5 years as is provided in the usual treaty). Otherwise the treaty will remain in force indefinitely. This rather short three-year period of time will give the two countries an opportunity to adjust the rules contained in the proposed convention as their experience dictates, after the initial 3-year period ends.

One of the more significant features of the proposed convention is that income which a resident of one country derives from commercial activities in the other country will be exempt from tax in the source

country unless it is attributable to an office or other place of business that the resident has in the source country. This feature of the proposed convention is similar to provisions contained in other U.S. tax conventions to the effect that industrial or commercial profits derived in a source country are exempt from tax unless the resident has a permanent establishment in the source country with which the income is effectively connected.

The proposed convention also provides that certain types of income are to be exempt from taxation in the source country even where the income is attributable to an office, or a representation, in the source country.

These exempt items of income are (a) rentals or royalties for the use of patents, copyrights, equipment and know-how; (b) payments for engineering, architectural and other technical services; (c) interest on indebtedness in connection with the financing of trade between the two countries; (d) reinsurance premiums; and (e) income from the sale of goods or services through a commission agent of independent status. While the method of dealing with these items is different from that found in other U.S. tax treaties, the results obtained are consistent with those found in the other treaties.

The other more important features of the proposed convention are the following:

(1) The United States and the Soviet Union are defined to include their respective continental shelves insofar as income arising from the exploration and exploitation of natural resources on the continental shelf is concerned. The effect of this provision is to recognize a country's jurisdiction to tax income arising in connection with natural resource activities on that country's continental shelf.

(2) A reciprocal exemption is provided for income and gains from shipping and air transportation.

(3) A reciprocal exemption is provided on income from personal services if the individual is present in the host country for 183 days or less and will be exempt for longer periods if the individual falls into a specified category such as a teacher or student.

(4) A specific prohibition is provided against one of the countries subjecting a citizen of the other country who is residing in the host country to more burdensome taxes than a citizen and resident of the host country. Also a business or office established by a resident of one country in the other country is not to be subjected in that other country to more burdensome taxes than are generally imposed in that other country on businesses or offices of residents of third countries carrying on the same activities.

GENERAL EXPLANATION

Article 1. Taxes covered

The proposed convention applies to the U.S. Federal income tax. It is intended that the proposed convention not apply to any U.S. taxes which are in the nature of a penalty (such as the accumulated earnings tax and the personal holding company tax). In the case of

the U.S.S.R., the proposed convention applies to all taxes and dues imposed by legislation at the national level. Among the taxes and dues imposed by the U.S.S.R. at the national level are a personal income tax, a transfer of a portion of the profits of State enterprises to the State, and a turnover tax. State and local taxes of the United States and Republic taxes, duties, and dues imposed by the Union Republics of the U.S.S.R. generally are not included in the proposed convention.

The proposed convention also contains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar taxes which either country may subsequently impose. Since the Soviet Union is presently studying how other nations tax nonresidents this provision is of significant importance.

Additionally, it is provided that the exemption from taxation for income from specific types of transactions is to apply to all transaction taxes imposed by the Internal Revenue Code and all national taxes imposed by the Soviet Union (Article IX). The mutual agreement provisions (Article XI) and the exchange of information provisions (Article XII) also apply to all national taxes. The nondiscrimination provisions apply to taxes of every kind imposed at the national, Republic or State, or local level.

Article 2. General Definitions

The standard definitions found in most of our income tax treaties are contained in the proposed convention. However, unlike more recent conventions, no procedure for establishing the meaning of undefined terms is provided.

In addition, the proposed convention contains a provision which is contained in the more recent U.S. treaties which includes within the definition of the term "United States" the territorial sea of the United States and the continental shelf of the United States insofar as the exploration and exploitation of natural resources on the continental shelf are concerned. This expanded definition, however, is applicable for purposes of the proposed convention only to the extent that the person, property, or activity of concern is connected with the exploration and exploitation of natural resources. A similar definition of the U.S.S.R. is contained in the proposed convention. The definition of continental shelf areas contained in the proposed convention is similar to that contained in the recent conventions with Trinidad and Tobago, Belgium, and Norway and to that provided in the Internal Revenue Code, except that under the Code the continental shelf definition applies only with respect to mines, oil and gas wells, and other natural deposits. In practical operation, however, the convention provision will be similarly restricted to the provision of the Code. The activity of fishing is not intended to be considered the exploration or exploitation of natural resources of the continental shelf, and as a result the definition of continental shelf is not to apply with respect to this activity.

Article III. Exempt Items of Income

Under the proposed convention, certain types of income (set out below) derived by a resident of one country are exempt from taxation by the other country. Moreover, the exemption applies even though the resident has a representation (permanent establishment) in the coun-

try in which the income is derived and the rights or property giving rise to the income is effectively connected with that representation. Generally, under the U.S. tax treaties the country of source has the right to tax income attributable to a permanent establishment located within its borders. As a result the proposed exemption is broader than under other U.S. income tax treaties.

The proposed convention provides an exemption for rentals, royalties, and other amounts paid as consideration for the use of, or the right to use, literary, artistic, and scientific works, amounts paid for the use of copyrights of these works, patents, industrial designs, processes or formulae, computer programs, trademarks, service marks, or other similar property or rights for industrial, commercial, or scientific equipment, or for knowledge, experience, or skill (know-how). Gains derived from the sale or exchange of these rights or property are also exempt whether or not the amounts realized on the sale or exchange are contingent (in whole or in part) on the extent and nature of the use or disposition of these rights or property. While the exemption in the proposed convention is broader than in other treaties in that the attribution of the payments to a permanent establishment does not terminate the exemption, it is not expected to be broader in practice, since these types of payments are not usually atrributable to a permanent establishment.

The proposed convention also provides that gains from the sale (or other disposition) of real or personal property received as an inheritance or gift is exempt from taxation by the country of source if derived by a resident of the other country. This provision does not affect the estate tax, but only the gain on the disposition of the property by the heir. In most cases this provision will have little significance since generally no capital gains tax is imposed on a nonresident alien unless present in the United States for more than 183 days during the taxable year. This exemption could have some limited impact, however, in those cases where the inherited property is being used in a trade or business in the United States. When property is so used, the 183-day exemption does not apply under the tax law and absent the treaty provision a tax otherwise would be imposed under the Code.

It is doubtful, however, whether this provision will have any practical significance since it is illegal for Soviet residents to own property outside of the Soviet Union. Any property which a Soviet resident might inherit in the United States would have to be disposed of immediately.

The proposed convention also exempts from tax in the source country income from the furnishing of engineering, architectural, designing, and other technical services in connection with an installation contract with a resident of that country. However, for this rule to apply, the services must be performed within a period not exceeding 36 months in one location. For example, if a U.S. resident derives income from sources within the Soviet Union, the United has exclusive taxing jurisdiction under the proposed convention if the income was derived from the furnishing of engineering services in connection with a contract with a Soviet resident but only if the services were carried out in a period not exceeding 36 months at one location. Similar results are achieved under the permanent establishment articles of

other U.S. income tax conventions. The definition of resident in Article II of the proposed convention indicates that this exemption is not applicable for services performed for a governmental agency but is applicable to state trading companies.

The proposed convention also provides that income derived from sources within one country by a resident of the other country from the sale of goods or the supplying of services through a broker, general commission agent, or other agent of independent status, acting in the ordinary course of his business, is exempt from tax in the country of source. This provision does not exempt the broker but rather the entity making use of the broker.

It is important to understand the operation of Soviet foreign trading activities in order to understand this provision. In the Soviet Union, foreign trade is the responsibility of governmentally controlled State foreign trading organizations, which are generally operated by and subordinate to the Ministry of Foreign Trade. These State foreign trading organizations are organized along commodity lines. They are authorized to purchase and sell commodities, patents, and technology within their specified commodity areas. A few of these State foreign trading organizations are authorized to trade within particular geographic regions, and a few organizations are charged with providing such auxiliary functions as insurance, freight forwarding, advertising, and tourism.

In an exchange of letters between the Soviet Union and the United States, it is clarified that Soviet foreign trading organizations perform the functions of an independent broker or general commission agent for various Soviet industrial and other organizations in the purchase of goods and services from foreign suppliers. Therefore, a representation of a U.S. commercial organization in the Soviet Union which makes sales to a State foreign trading organization is to be regarded as making sales through a broker or general commission agent, and the income of the representation from these sales will be exempt from tax by the Soviet Union.

The exchange of letters also provides that, with respect to the Soviet Union, a firm acting in the United States as a broker, general commission agent, or other agent, for a State foreign trading organization will not be considered to be of independent status if it is owned or otherwise controlled by an authorized organization of the Soviet Union. This understanding has the effect of providing that a Soviet foreign trading organization is not exempt from U.S. tax if the organization's representation in the United States sells through a "second" State foreign trading organization also having a representation in the United States since the second State foreign trading organization is not treated as having an independent status by reason of being owned or controlled by the first organization. Under these rules the first organization is subject to U.S. tax on its commission income.

However, if a Soviet foreign trading organization sells in the United States through an independent broker the trading organization is not subject to tax on its profits. The broker must be more than a mere accommodation party and must be the party which makes the sales in the ordinary course of its trade or business. This provision is not satisfied if, for example, the trading organization actively solicits customers and then has the sale made through the broker.

Exempting the income of a representation of a nonresident from taxation in the country of source is contrary to the other U.S. income tax conventions, which provide that income attributable to a permanent establishment located in the source country is taxable in that country. However, since in many cases U.S. firms are able to sell goods without establishing a permanent establishment in the source country, this difference should not be very significant, particularly since U.S. permanent establishments in the U.S.S.R. are likely to be limited.

The proposed convention also provides that income from premiums for the reinsurance of property or risks derived from sources within one of the countries is exempt from tax in that country. Any income derived from insurance premiums, however, is not exempt under this provision.

The proposed convention provides that interest on credits, loans, and other forms of indebtedness connected with the financing of trade between the United States and the Soviet Union is exempt from tax in the country of source. No definition is provided of what is intended by the word "trade." Presumably, it includes the sale of goods, services, and technology. Under this rule, a representation in the Soviet Union of a U.S. resident is exempt from taxation by the Soviet Union on interest received on loans used to finance sales to the Soviet Union. An exception to this rule is specifically provided so that interest received by a resident of one country from the conduct of a banking business in the source country is not exempt in the source country.

The proposed convention also provides that income is not to be attributed by a country to certain activities conducted within that country by a resident of the other country. Thus, a country is not to attribute income to the purchase of goods or merchandise within that country by a resident of the other country. Similar rules also apply to the following activities: the use of the facilities for the purpose of storage or delivery of goods or merchandise belonging to the resident of the other country; the display of goods or merchandise belonging to the resident of the other country, and also the sale of these items on termination of their display if they are not carried on the resident's inventory; and advertising by a resident of the other country, the collection or dissemination of information, or the conducting of scientific research, or similar activities, which have a preparatory or auxiliary character for the resident.

This provision of the proposed convention generally reaches the same result as other U.S. income tax conventions. That is, these activities generally appear as activities which will not create a permanent establishment. Further, other U.S. tax conventions provide that profits will not be attributed to a permanent establishment in the case of its purchase of goods or merchandise.

Article IV. Representation

Under the proposed convention, income derived from commercial activities in one country by a resident of the other country is taxable in the source country only to the extent it is attributable to a representation which the resident has in the source country. This concept, usually referred to as a permanent establishment in other U.S. income tax conventions, is one of the basic devices used in income tax treaties to avoid double taxation. The term "representation" was used to accommodate the Soviet Union.

The term "representation" means an office, representative bureau, or other place of business established in one of the countries by a resident of the other country in accordance with the laws and regulations governing the formation and licensing of businesses (including Republic or State, or local laws) in force in the source country. This definition is not as complete a definition of permanent establishment as appears in the OECD model convention and other U.S. income tax treaties.

In computing the taxable business profits, the proposed convention allows the deduction of all expenses, wherever incurred, which are reasonably connected with the business profits.

Article V. Shipping and air transport

The proposed convention provides for a reciprocal exemption of profits from ships or aircraft operated in international traffic. Under the provision, the country of source is to exempt the income of a resident of the other country derived from the operation in international traffic of ships or aircraft which are registered in the country of the resident. The exemption also applies to gains from the sale or exchange of a ship or aircraft the income from the operation of which was exempt under the treaty. In addition, the proposed convention provides that remuneration derived by an individual from the performance of labor or personal services as an employee aboard a ship or aircraft operated by one of the countries or a resident of that country in international traffic is to be exempt from tax in the country of source if the individual is a member of the regular complement of the ship or aircraft. The provisions of this article of the proposed convention are similar to those found in most U.S. tax conventions. In an exchange of letters accompanying the proposed convention it is agreed that each country will use its best offices to secure exemption from income taxation at the Republic or State or local levels which may be imposed on the operations of ships or aircraft. The United States has expressed a willingness to undertake this commitment in connection with a number of other recently ratified tax conventions.

Article VI. Exemptions for individuals

The proposed convention provides for a series of exemptions for income earned by an individual who is a resident of one country from personal services performed in the other country.

The first exemption provides that a citizen of one country receiving remuneration from that country for labor or personal services performed as an employee of a governmental agency or institution of that country "in the discharge of governmental functions" is exempt from tax by the other country. Individuals who are employed in commercial activities are not considered to be engaged in the discharge of governmental functions. The exemption does not extend to Republic or State or local governmental employees. This exemption is similar to exemptions provided in other U.S. tax conventions except that some of these conventions exempt local governmental employees.

The proposed convention provides that the definition of governmental functions is defined under the internal laws of the country paying for the services. However, persons engaged in commercial activity such as employees or representatives of commercial organizations and employees of the foreign trade organizations of the U.S.S.R.

are not considered as engaged in the discharge of governmental functions.

Second, the proposed convention provides that a resident of one country who is temporarily present in the other country under an exchange program provided for by agreement between the two countries in various fields of science and technology is exempt from tax in the source country on remuneration received from sources within either country. In no case does the period of exemption under this provision extend for more than one year. This provision is similar to provisions found in other U.S. tax conventions, except that there generally is a dollar limitation.

Third, a resident of one country who is temporarily present in the other country, at the invitation of a governmental agency or an educational or scientific research institution in that other country for the primary purpose of teaching, engaging in research or participating in scientific technical or professional conferences, is exempt from tax in the source country on his income from teaching, research, or participation in the conference. This exemption does not apply to research undertaken primarily for the benefit of a private person or commercial enterprise in the United States or a foreign trade organization of the U.S.S.R. However, the exemption does apply in all cases where the research is conducted on the basis of intergovernmental agreements of cooperation. In no case, however, does the period of exemption extend for more than two years.

In an exchange of notes accompanying the proposed convention, the two countries agreed that the exemption accorded teachers and researchers is to be extended to journalists and correspondents on compensation received from abroad for periods not exceeding two years. A special exemption for reporters and correspondents is not found in any other U.S. tax treaty. It is understood that this exemption was agreed to because U.S. correspondents apparently are the only foreign correspondents subject to tax in the Soviet Union. However, the Soviet Union has indicated it will only grant this exemption on a reciprocal basis.

Although the United States has tax conventions with a number of countries providing for exemptions for researchers and teachers, in none of these conventions has that exemption been construed to include journalists and correspondents. While it may well be appropriate to extend on a reciprocal basis a limited exemption to correspondents and journalists, it is difficult to see the basis in the treaty language for this exemption. Providing of an exemption through an exchange of notes without a basis in the treaty might well be viewed as a precedent, ratifying the right of the Executive Department to grant special exemptions from the tax law by means of an exchange of notes. However, it is noted that the exchange of notes was transmitted to the Senate along with the proposed tax convention and could be viewed as being submitted to the Senate for its advice and consent. If the Executive Department makes it clear that its intent was to request the advice and consent of the Senate on the exchange of notes, then the correspondents and journalists provision could be approved in accordance with the normal procedures for approving treaties.

Fourth, the proposed convention provides that a resident of one country who is temporarily present in the other country for the pri-

mary purpose of studying at an educational or scientific research institution or for the purpose of acquiring a profession or a specialty is to be exempt from tax in the host country on a stipend, scholarship, or other substitute type of allowance necessary to provide for ordinary living expenses. The exemption under this provision is not to be for a period exceeding 5 years. In an exchange of notes acompanying the proposed convention, it was agreed that the "ordinary living expense" would be less than $10,000 (or its equivalent in rubles) for each taxable year to be determined for each student on a case-by-case basis. An exemption for students is generally found in most U.S. tax conventions.

Fifth, the proposed convention provides that a resident of one country who is temporarily present in the other country for the primary purpose of acquiring technical, professional, or commercial experience or performing technical services and who is an employee of, or under contract with, a resident of his country of residence is to be exempt in the source country on remuneration received from abroad. Also, the trainee or specialist is exempt from tax in the source country on amounts received from sources within that country which are necessary to provide for ordinary living expenses. The exemption provided for by this provision is not to apply for a period of more than 1 year. In an exchange of notes accompanying the proposed convention, it was agreed that the exemption in any taxable year is not to exceed an amount in excess of $10,000 (or its equivalent in rubles). An exemption of this type is generally found in U.S. tax conventions; however, it is not extended to individuals performing technical services.

Finally the proposed convention provides that the exemptions provided for individuals which apply to a limited number of years are to be computed on a cumulative basis if more than one exemption applies to an individual. However, in no case are the cumulative benefits to be for more than five taxable years from the date of the individual's arrival in the source country.

If an individual is not entitled to one of these special exemptions provided in the proposed treaty he is to be exempt from tax by the source country if he is present in that country for a period aggregating no more than 183 days in the taxable year. Somewhat similar results are reached under other U.S. income tax conventions.

Article VII. Citizens

The proposed convention contains a provision found in most U.S. tax conventions that the convention does not restrict the right of a country to tax its citizens. Thus, for example, the United States may tax its citizens whether or not they are residents of the U.S.S.R. A provision of this nature is found in most U.S. tax conventions; however it generally applies to residents, as well as citizens.

Article VIII. Illegal Activities

The proposed convention provides that the benefits of the convention are available only to the taxation of income from activity conducted in a country in accordance with the law and regulations in force in that country. There is no definition of the laws which are to be taken into account for purposes of this provision. Thus, it would appear that this provision applies to all criminal, civil, and procedural laws and regulations which may be in force in a country at the na-

tional, Republic or State, and local level. This feature of the proposed convention makes each treaty country, in effect, the sole judge as to whether it wishes to extend treaty benefits to a particular individual or company since each country would be making a determination as to whether an activity was being conducted in accordance with its laws. It is understood that this article was inserted at the request of the Soviet Union. There is no comparable article to this in any other U.S. income tax convention.

Article IX. Taxes on Transactions

The proposed convention provides that if the income of a resident of one country is exempt from tax under the convention by the other country, the resident is also to be exempt from any tax which is at present or may subsequently be imposed by the source country on the transaction which gives rise to the income. At the present time the only transaction which will be entitled to a U.S. tax exemption under the proposed convention is the excise tax on insurance and reinsurance premiums paid to a foreign company for the insurance of risks located inside the United States. The rate of tax is presently four cents per dollar of premiums on casualty insurance and one cent per dollar of premium on life, accident, and health insurance and on reinsurance. This excise tax is not frequently imposed since most foreign insurance companies have offices within the United States through which they sell their insurance or reinsurance. No similar provision appears in any U.S. income tax convention.

In an exchange of notes accompanying the proposed convention the two countries agreed that custom duties do not come within the scope of this exemption from taxes on transactions.

Article X. Non-Discrimination.

The proposed convention contains a non-discrimination provision which differs somewhat from the more comprehensive non-discrimination provisions which have appeared in more recent U.S. income tax conventions. The proposed convention provides that a citizen of one country who is a resident of the other country is not to be subjected to more burdensome taxes in that other country than a citizen of that other country who is a resident thereof, carrying on the same activities. Further, a citizen of one country who is a resident of the other country, or a representation established by a resident of one country in the other country, is not to be subjected in that other country to move burdensome taxes than are generally imposed in that other country on citizens or representations of residents of third countries carrying on the same activities. In applying this provision, a country is not required to grant to citizens or representations of residents of the other country tax benefits granted by special agreements to citizens or representations of third countries.

It is understood that the reason that the non-discrimination provision is to be determined with reference to treatment of third country representations rather than to local entities such as corporations, as is done in other U.S. tax treaties, is due to the nature of business taxation in the U.S.S.R. The lack of comparable Soviet entities made it more relevant to compare representations of U.S. residents with third country representations. The provisions in this article of the proposed convention apply to all taxes whether imposed at the national, Republic or

State, or local level. However, in an exchange of notes accompanying the proposed convention, it was agreed that customs duties are not to be considered as taxes for the purposes of the non-discrmination provisions.

Articles XI and XII. Administrative Provisions.

The proposed convention contains some of the various administrative provisions found in other U.S. tax conventions. In general the proposed convention provides for consultation and negotiation between the two countries to resolve differences arising in the application of the proposed convention, and also to resolve claims by taxpayers that they are being subjected to taxation contrary to the terms of the proposed convention. Further, the proposed convention provides for notification on an annual basis of any amendments of the tax legislation which is the subject matter of the convention or of any other material concerning the application of the proposed convention.

Article XIII. Entry into Force

The proposed convention will enter into force on the 30th day following the exchange of instruments of ratifications. The provisions of the proposed convention, however, will have effect for income derived on or after January 1 of the year following the year in which the instruments of ratification are exchanged.

Article XIV. Termination

The proposed convention will continue in force indefinitely. However, either country may terminate it at any time after 3 years from its entry into force by giving notice through diplomatic channels. In addition, the provisions of Article III dealing with independent brokers, reinsurance, and interest on credits connected with the financing of trade and the provisions of Article IX dealing with exemptions for transaction taxes may be terminated separately at the end of the 3-year period.

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